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IN THE

Supreme Court of the United States

OCTOBER TERM, 1962

No. 549

RAYMOND H. WITTE AND LILLIAN B. WITTE,
Petitioners,

v.

UNITED STATES OF AMERICA,
Respondent.

PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE FIFTH CIRCUIT

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RAYMOND H. WITTE AND LILLIAN B. WITTE,
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UNITED STATES OF AMERICA,
Respondent.

PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE FIFTH CIRCUIT

To The Honorable The Chief Justice And The Associate Justices Of The Supreme Court Of The United States:

Petitioners, Raymond H. Witte and Lillian B. Witte, pray that a writ of Certiorari issue to the United States Court of Appeals for the Fifth Circuit. The Trial Court held that the proceeds generated by the sale of sand and gravel leases constituted capital gain and granted refund to Petitioner for additional income taxes for the years in question. The United States Court of Appeals for the Fifth Circuit reversed the Trial Court and held the proceeds ordinary income subject to depletion.

OPINIONS BELOW

The opinion of the Trial Court, the United States District Court for the Western District of Louisiana, Lake Charles Division, is reported in *Raymond H. Witte, et ux* v. *United*

States of America, 201 F. Supp. 525 (1960).[1] The opinion of the Court of Appeals for the Fifth Circuit is reported in *United States of America* v. *Raymond H. Witte, et ux*, 306 F. 2d 81 (C.A. 5, 1962) (*infra*, Appendix A, pp. 1a-15a).

JURISDICTION

The judgment of the Court of Appeals was entered on July 25, 1962 (*infra*, Appendix B, p. 16a). No petition for rehearing was filed. The jurisdiction of this Court is invoked under 28 U.S.C.A., Sec. 1254 (1).

QUESTIONS PRESENTED

The questions presented by this petition are as follows:

1. Whether, in the sale of a partnership interest, which includes sand and gravel leases, amounts paid to the selling partners as the sand and gravel are removed are to be taxed as ordinary income subject to depletion, or entitled to capital gains treatment.

2. Whether, where the selling partners receive annual payments measured by the amount of sand and gravel produced from the properties sold, the sellers retain an economic interest in the sand and gravel so as to make the income attributable thereto ordinary income subject to depletion.

STATUTES INVOLVED

The statuary provisions are as follows:

Int. Rev. Code of 1939, Sec. 117;
Int. Rev. Code of 1954, Secs. 741 and 751.

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[1] Inasmuch as nine additional copies of the record as printed for the use of the Court of Appeals have been filed pursuant to Rule 21(4), the opinion of the Trial Court is not appended to this Petition. Rule 23(1)(i).

The provisions of these statutes are printed in Appendix C hereto (*infra* pp. 17a-19a).

STATEMENT

The taxpayers (referred to herein as Petitioner) are Raymond H. Witte and wife, Lillian B. Witte, who are residents of the City of Lake Charles, Louisiana. (R. 111) Raymond H. Witte along with S. Perry Brown and C. W. Lane, were partners in Louisiana Sand and Gravel Company, a partnership which was engaged in the business of producing and marketing sand and gravel and related products in the vicinity of Kinder, Louisiana. (R. 68, 111, 112) The assets of the partnership consisted of certain sand and gravel properties, equipment, and other assets required in the mining and marketing of sand and gravel. (R. 68, 69, 112)

Prior to January 1, 1953, the partners concluded to sell the business and expressed an intent to so do. (R. 69, 112) As a result of their inquiries and negotiations with the Murchison interests, in August of 1952, Petitioner prepared an inventory of the equipment and improvements of the partnership in order to arrive at a possible sales price of the business. (R. 68, 112) During the negotiations for the sale of the business, a representative of the Murchison interests, Mr. Pickens, had test core holes drilled for his examination in order to verify the Petitioners' estimates of sand and gravel reserve deposits of 40 million tons. (R. 65, 66, 112) After negotiation of the transaction, and by instruments dated February 20, 1953 (but effective January 1, 1953), for a total consideration of $1,578,550.53, Witte Gravel Company, a Delaware corporation organized and owned by the Murchison interests, acquired the sand and gravel assets of R. H. Witte, Petitioner, S. Perry Brown and C. W. Lane in the Parishes of Calcasieu, Jefferson

Davis, Allen, Beauregard, Evangeline, St. Landry, Acadia, Cameron, Vermilion and Lafayette. (R. 112)

Except for cash, accounts receivable and insignificant miscellaneous assets of nominal value, Witte Gravel Company acquired all of the assets of Louisiana Sand and Gravel Company, and all of the related assets of R. H. Witte, Petitioner, S. Perry Brown and C. W. Lane, and, in addition to the equipment and the rights to sand and gravel reserves, a railroad company with related assets, unfilled orders for sand and gravel and related products and all of the other assets used in this sand and gravel business. (R. 113)

The transaction was effected in separate instruments so that only a minimum of information would have to be filed for public record, due to several expropriation suits of a particularly bitter nature which were pending at that time. (R. 113)

One instrument was filed for public record, a chattel mortgage of the conveyed equipment, containing the standard provisions and providing for a mortgage on the equipment in the amount of $578,550.53. (R. 113; Ex. 3-C, R. 154-176).

Witte Gravel Company gave Petitioner and his partners its promissory note for $578,550.53, payable in sixteen (16) equal quarterly installments, commencing March 31, 1953, with interest at the rate of four percent (4%) per annum on the unpaid balance, endorsed by the Murchison Brothers, and secured by a chattel mortgage of the equipment. (R. 113; Ex. 2-B, R. 150-153). Petitioner and his partners gave Witte Gravel Company a bill of sale to the equipment in consideration of the promissory note of $578,550.53, and entered into an agreement, providing, among other things, that Petitioner would not compete with Witte Gravel Company for fifteen (15) years. (R. 113; Ex. 1-A, R. 143-149).

Petitioner and his partners conveyed the sand and gravel properties as of January 1, 1953, including the income realized after such date, and agreed to a restriction against competition for a period of fifteen (15) years. (R. 113; Ex. 4-D, R. 177-193) This conveyance and agreement provided in part as follows:

> "Except insofar as this Conveyance and Agreement covers and pertains to the instrument described under (3) above, there is by Assignors excepted from this assignment and expressly reserved unto themselves and their respective heirs, representatives and assigns, in equal one-third (1/3) shares, as a limited overriding royalty interest or production payment that shall be delivered to the credit of Assignors, their respective heirs, representatives or assigns, an undivided fractional percentage of all sand and/or gravel, in, on or under and to be produced, saved and sold from the lands, or any part thereof, covered by the above-described instruments of lease and/or sale and conveyance (except the instrument described under number (3) above) sufficient to yield, at the rates and in the manner hereinafter set forth, the full net sum of One Million Dollars ($1,000,000.00); it being expressly agreed and provided that hereby Assignors do not reserve or retain unto themselves, their respective heirs, representatives or assigns, any interest in or under the instrument described under (3) above, or any interest or fractional percentage in or to any of the sand and/or gravel in, on or under the lands covered thereby or that may be produced, saved and sold therefrom. Said limited overriding royalty or production payment shall be payable out of the proceeds of the sale of sand and/or gravel, and only out of same and not otherwise, as follows:
>
> "(a) Five cents (5¢) per ton on the first 300,000 tons of sand and/or gravel produced, saved and sold from the above described premises or any part of

them (except the premises covered by the instrument described under (3) above) in each particular year beginning January 1, 1953, and ending December 31, 1956, plus ten cents (10¢) per ton on all tons of sand and/or gravel produced, saved and sold in excess of 300,000 tons from said premises in any such particular year during such four-year period, and from and after January 1, 1957, ten cents (10¢) per ton on all tons of sand and/or gravel produced, saved and sold from such premises (except the premises covered by the instrument described under number (3) above), until from all of same Assignors shall have received the full net sum of Seven-Hundred Fifty Thousand Dollars ($750,000.00); and

"(b) Thereafter, that is to say after Assignors have received the full net sum of $750,000.00, two cents (2¢) per ton on all tons of sand and/or gravel produced, saved and sold from said premises (except the premises covered by the instrument described under number (3) above) until Assignors shall have received the full net sum of Two Hundred Fifty Thousand Dollars ($250,000.00).

"Accounting for, and payments accruing to Assignors under and by virtue of, such retained limited overriding royalty or production payment shall be made quarterly, beginning March 31, 1953, with the accounts to be rendered and the payments to be made to Assignors not later than twenty (20) days after each such accounting period." (R. 114-115; Ex. 4-D, R. 183-185)

Petitioner and others had determined that there were forty million (40,000,000) tons of sand and gravel available from the conveyed properties, of which sixty percent (60%), or twenty-four (24) million tons, had an immediate market, thus providing more than ample proven sand and gravel reserves to insure the payment of the one million dollars. (R. 65, 115)

Petitioner had determined that the value of the equipment as of August 18, 1952, when negotiations were undertaken with the purchasers, was $1,013,694.80. (R. 69, 115)

The transaction was the sale of a going partnership business complete even to restrictions against competition by the sellers for a period of fifteen (15) years. (R. 116; Ex. 1-A, R. 146-147) The transaction was a sale collectively by the individual partners of their individual interests in the partnership (R. 116) The full title to all interests of the partnership in all of their properties, including the sand and gravel leases, passed and vested in the buyer. (R. 116)

On or before March 16, 1954, Petitioner duly filed his 1953 Federal Income Tax return and paid the tax set forth therein, $35,766.20. (R. 117) During 1953, Petitioner received and reported as long-term capital gain $9,035.14, which had been received in payment for the sale of his partnership interest in Louisiana Sand and Gravel Company. (R. 117) The Commissioner of Internal Revenue has determined that during 1953 the Petitioner realized from the sale of the Louisiana Sand and Gravel Company $24,095.92 ordinary income. (R. 117) The Commissioner of Internal Revenue has determined that during 1953 the Petitioner realized $479.47 short-term capital gain from the sale of certain assets which had been held by the Louisiana Sand and Gravel Company partnership for less than six months. (R. 117-118) On April 1, 1958, Petitioner paid to the District Director of Internal Revenue for the District of Louisiana, at his Lake Charles, Louisiana office, the sum of $3,081.96, with interest thereon of $747.79, being the deficiency assessed in the said statutory notice of deficiency. (R. 118) On or before April 15, 1955, Petitioner duly filed his 1954 Federal income tax return, and paid the tax set forth therein, $8,695.78. (R. 118) During 1954 the Petitioner received and

reported as long-term capital gain $40,674.04, which had been received in payment for the sale of his partnership interest in Louisiana Sand and Gravel Company. (R. 118) The Commissioner of Internal Revenue has determined that during 1954 the Petitioner realized from the sale of the Louisiana Sand and Gravel Company $17,929.75 ordinary income. (R. 118) The Commissioner of Interal Revenue has determined that during 1954 the Petitioner realized $1,917.87 short-term capital gain from the sale of certain Louisiana Sand and Gravel Company assets which had been held by the partnership for less than six months. (R. 118) On April 1, 1958, Petitioner paid to the District Director of Internal Revenue for the District of Louisiana at his Lake Charles, Louisiana office, the sum of $4,395.97, with interest thereon of $781.16, being the deficiency assessed in the said statutory notice of deficiency. (R. 118) On April 2, 1958, Petitioner filed with the District Director of Internal Revenue, District of Louisiana, New Orleans, Louisiana, Lake Charles office, two claims for refund, one being for the year 1953 and the other being for the year 1954. (R. 118, 119) The 1953 claim is for $965.06, plus interest paid thereon of $234.06, plus interest of six (6%) percent per annum from April 1, 1958 on the total of the overpayment of taxes, and interest, $1,199.12. It was the contention of the Petitioner in the Trial Court that the Commissioner illegally and erroneously determined that (1) Petitioners during 1953 realized $7,486.59 ordinary income, subject to $374.33 depletion from the transaction, and (2) Appellee during 1953 realized $1,438.41 short-term capital gain from the sale of certain assets which had been held by the partnership for less than six months. (R. 119) The 1954 claim is for $4,395.97, plus interest paid thereon of $781.16, plus interest of six percent (6%) per annum from April 1, 1958 on the total of the overpayment of taxes and interest, $5,177.13. It was the conten-

tion of the Petitioner in the Trial Court that the Commissioner illegally and erroneously determined that (1) Petitioners during 1954 realized $50,924.57 ordinary income, subject to $2,546.23 depletion from the transaction, and (2) Petitioners during 1954 realized $5,753.61 short-term capital gain from the sale of certain assets which had been held by the partnership for less than six months. (R. 119)

The Trial Court concluded that a bona fide sale was consummated by the parties and that the amounts received represented capital gains from the sale of a capital asset. (R. 122) The Court of Appeals, with one judge dissenting, reversed holding the amounts received ordinary income subject to depletion. (C.A. Op., *infra*, pp. 1a-15a)

REASONS FOR GRANTING THE WRIT

I. The decision of the Court of Appeals shows that the Court failed to apply accepted rules of law after concluding that the transaction involved constituted the sale of a partnership business, thereby resulting in a decision which is in conflict with decisions of this Court, and in conflict with decisions of other Courts of Appeal.

From the very outset of the controversy with Respondent, the contention of the Petitioner has been the same. Petitioner has not varied from the contention and reurges it now — that this transaction was the sale of a partnership interest in a sand and gravel business and thereby the sale of a capital asset entitled to capital gains treatment. Respondent on the other hand, has taken the position that upon the transfer of the assets to Witte Gravel Company, the partners in the Louisiana Sand and Gravel Company retained an economic interest in the sand and gravel in place, so that their income attributable solely to the production and sale of sand and gravel was ordinary income subject to depletion.

The Honorable Edwin F. Hunter, Jr., United States District Judge for the Western District of Louisiana, Lake Charles Division, experienced no difficulty in concluding that the contention of the Petitioner was sound in the following language found in his opinion:

> "Looking beyond the mere phraseology of the agreement we find that the primary purpose of the transaction was not the exploitation of sand and gravel deposits, but the sale of a going business. (R. 121)

Quite interestingly enough, the Court of Appeals experienced no difficulty whatever in concluding that the facts under consideration did constitute the sale of a going partnership business:

> "* * * but we entertain no doubt that the taxpayer is right that this was, and has to be, regarded as a single transaction in which a going business enterprice was being transferred to entirely new ownership. Consequently, each paper, document, or conveyance, while important and enforceable in accordance with its own terms, is not to be looked upon as an isolated thing. All are to be treated as part and parcel of a continuous comprehensive transaction * * *" (C.A. Op., *infra*, p. 4a)

> "To effectuate the *sale*, four separate documents were used: * * *" (C. A. Op. *infra*, p. 4a)

Despite the fact that the Court of Appeals went along with the position of the Petitioner that this was a sale and went along with the decision of the Trial Court that the purpose of the transaction was the sale of a going business, it was not willing to let the matter rest there and give to Petitioner the benefit flowing from this conclusion. Rather the Court of Appeals fragmented the transaction and considered the sale of the sand and gravel leases separate and

apart from the remainder of the sale. It is submitted that the Court of Appeals fell into error in so doing.

It must be remembered that the facts in this case arose prior to the adoption of the 1954 Internal Revenue Code. Prior to 1950 there were two theories which were applied to the sale of a partnership interest, one being the "aggregate" theory and the other the "entity" theory. Under the aggregate theory, whether the gains were treated as ordinary income or capital gains depended upon the type of each item of property sold. Under the entity theory, each item of property was not considered separately. In 1950 the Internal Revenue Service adopted the entity theory. G. C. M. 26379, C. B. 1950-51 p. 58. In the 1954 Internal Revenue Code, the entity theory was continued and Section 741 provides the following:

> "In the case of a sale or exchange of an interest in a partnership, gain or loss shall be recognized to the transferor partner. Such gain or loss shall be considered as gain or loss from the sale or exchange of a capital asset, except as otherwise provided in Section 751 (relating to unrealized receivables and inventory items which have appreciated substantially in value."

The Court of Appeals, after concluding that the transaction was in fact the sale of a partnership business, should have gone no further than to refer to the Respondent's position as enunciated in G. C. M. 26379, C. B. 1950-1, p. 58. This was adopted by the internal revenue service for the express purpose of preventing what the Court of Appeals did, namely, fragmenting the sale as though the sale were a sale of the underlying assets.

Mertens, Law of Federal Income Taxation, Section 35.55, pages 166-167, states clearly the income tax consequences of the sale of a partnership interest:

> "The sale of a partnership interest is treated like the sale of a capital asset, and the gain or loss with respect thereto constitutes capital gain or loss. Under the 1939 Code such a sale is not a sale of the vendor's interest in the assets of the partnership, and the total gain or loss upon such a sale is not fragmented into capital and ordinary gain or loss as though a sale of the underlying assets had taken place. The same principle applies to the simultaneous sale by all the partners of their respective partnership interests to an outsider. The partners are each treated as having sold a capital asset as long as assets constituting substantially the entire business have been disposed of, regardless of the fact that the partnership was not dissolved and that certain minor assets may have been retained by it."

The cases are numerous which hold that the gain or loss from the sale of the partnership interest constitutes capital gain or loss. *Bell* v. *Comm.*, 219 F. 2d 442 (C.A. 5, 1955); *Comm.* v. *Smith*, 173 F. 2d 470 (C.A. 5, 1949); *Long* v. *Comm.*, 173 F. 2d 471 (C.A. 5, 1949), cert. den. 338 U. S. 818, 94 L. Ed. 496, 70 S. Ct. 61 (1949); *First National Bank of Mobile* v *Comm.*, 183 F. 2d 172 (C.A. 5, 1950). The foregoing Fifth Circuit Court cases show that Court following the entity theory and holding that the sale of a partnership interest is not fragmented into capital or ordinary gain or loss as though a sale of the underlying assets had taken place. A majority of the Circuit Courts are in accord with the Fifth Circuit in this respect: the Second Circuit, *Leff* v. *Comm.*, 235 F. 2d 439 (C.A. 2, 1956); *Helvering* v. *Smith*, 90 F. 2d 590 (C.A. 2, 1937); the Third Circuit, *Tunnell* v. *U. S.*, 259 F. 2d 916 (C.A. 3, 1958); the Fourth Circuit, *Doyle* v. *Comm.*, 102 F. 2d 86 (C.A. 4, 1939); the Ninth Circuit, *U. S.* v. *Snow*, 223 F. 2d 103, cert. den. 350 U. S. 831, 76 S. Ct. 64, 100 L. Ed. 741, *Trousdale v. Comm.*, 219

F. 2d 563 (C.A. 9, 1955). The Tax Court also holds in accord with the Fifth Circuit. *Estate of William Goldstein* v. *Comm.*, 29 T. C. 931; *Spicker* v. *Comm.*, 26 T. C. 91; *Johnson* v. *Comm.*, 21 T. C. 733. The Seventh Circuit appears to be in accord in its latest decision. *Hulbert* v. *Comm.*, 227 F. 2d 399 (C.A. 7, 1955). Some earlier cases in the Seventh Circuit followed the aggregate theory. *Meyer* v. *U. S.*, 213 F. 2d 278 (C.A. 7, 1954); *Swiren* v. *Comm.*, 183 F. 2d 656 (C.A. 7, 1950), cert. den. 340 U.S. 912, 71 S. Ct. 293, 95 L. Ed. 659. The Sixth Circuit follows the aggregate theory, *Berry* v. *U. S.*, 267 F. 2d 298 (C.A. 6, 1959), as does the Eighth Circuit, *U. S.* v. *Donoho*, 275 F. 2d 489 (C.A. 8, 1960), *U. S.* v. *Shapiro*, 178 F. 2d 459 (C.A. 8, 1949).

The majority opinion of the Court of Appeals in the subject case reaffirms its adherence to the entity concept. The Government argued that upon the sale of a going business, it is to be comminuted into its fragments so that the gain on each fragment is characterized as capital gain or ordinary income as the case might be. This argument advanced by the Government was summarily disposed of by the Court of Appeals by citing its own decision in the case of *Sherlock* v. *Commissioner*, 294 F. 2d 863 (C.A. 5, 1961), and in the following language:

> "* * * but as we recently pointed out, this court has long rejected the aggregate theory and has followed the entity concept in determining the tax consequences in the sale of a going business." (C.A. Op. *infra*, p. 3a, 4a).

The Honorable John R. Brown of the Court of Appeals, who wrote the opinion in the subject case, had dissented in the case of *Sherlock, supra*. In the *Sherlock* case the Court had under consideration the same matter being discussed here, namely, the sale of a partnership business, and the majority in that opinion reached the conclusion that where the taxpayer sold his partnership interest to former

partners prior to the end of the partnership's fiscal year, the amount of the taxpaper's share of undistributed earnings which accrued during that year were taxable to him as ordinary income and not as capital gain. The Honorable John R. Brown criticized the majority opinion in his dissenting opinion for he felt that the majority opinion was abandoning the entity concept to which the Fifth Circuit Court had committed itself. In his dissenting opinion in the *Sherlock* case at page 867, the Honorable John R. Brown stated the following:

> "I do not understand how the entity concept, firmly and long since adopted by this Court, can coexist with the hybrid contention that while the interest sold is an indivisible part of the whole entity, this does not include as a part of that entity that which, absent a sale of all, would have been taxable as ordinary income.
>
> "I recognize, of course, that courts continue to see a distinction but what they are in fact applying is but a sugar-coated version of the now-rejected aggregate theory that the microscope must be put on each and every asset, right or claim being effectually transferred in order to determine what would have been payable had the entire sale not been made.
>
> ". . .The transaction is a sale of an entire interest. It is the sale which is the decisive factor. What is sold is not merely the right to receive income theretofore earned and thereafter to be realized from past operations. It comprehends everything. The everything happens to include as an indivisible part what has been, or will shortly be, earned from prior operations. The sale of all is the thing. Devoted as we are to the proposition that the sauce is for goose or gander alike with a strict neutrality whether it helps or hinders government or taxpayer, Weinert v. Commissioner, 5 Cir., 1961, 294 F. 2d 750 this determines the tax consequence of that transaction. It is not determined by what might have been but never was. General Gas Corporation v. Commissioner, 5 Cir., 1961, 293 F. 2d 35."

The Honorable John R. Brown, in the instant case, has fallen into the error which he so vigorously criticized in the *Sherlock* case. A careful study of the *Sherlock* case shows that the facts are not in any way parallel to those of the subject case and that case cannot form the basis for the decision in the subject case. Quite clearly the majority opinion of the Court of Appeals is not based upon the *Sherlock* case except to the extent that the *Sherlock* case held that the aggregate theory rather than the entity theory should be applied.

When considering the tax consequences of the sale of a partnership interest, it is apparent from the decided cases that those courts following the entity concept have been concerned with only two matters, the first being whether in fact there was a sale, and the second being whether the sale includes an underlying asset which has been treated by previous Code provisions (and now treated by the specific provisions of the 1954 Code) as an "income" item. The matter of whether under the circumstances presented there was in fact a sale was considered by the court in *Estate of Hatch* v. *Commissioner*, 198 F. 2d 26 (C.A. 9, 1952). There the partners contracted for the sale of their partnership business, retaining cash, two automobiles, the garage and debts. The partnership continued afterwards as an entity with these assets, and the court held that there was a sale. See also *Haggard* v. *Wood*, 298 F. 2d 24 (C.A. 9, 1961) On the other hand in the following cases even though the court found a sale, it looked to underlying assets and held them to generate ordinary income upon finding that a particular statutory provision required such treatment: *Williams* v. *McGowan*, 152 F. 2d 570 (C.A. 2, 1945), *Watson* v. *Commissioner*, 345 U. S. 544, 73 S. Ct. 848 (1953), *Hogan* v. *Commissioner*, 141 F. 2d 92 (C.A. 5, 1944).

The majority opinion of the Court of Appeals indicates that the Court experienced no difficulty in concluding that the facts showed clearly a sale. The Court of Appeals then looked to the underlying asset consisting of the sand and gravel leases and determined that these leases should be reckoned apart from the remainder of the sale. It is obvious from the Court of Appeals opinion that the Court did not find a particular Code provision that the leases would fit into which would dictate that the income therefrom be found ordinary income. With the case in this posture it was incumbent upon the Court, based upon established precedent, to treat the gain from the sale of these leases as capital gains.

The Petitioner does not desire to belabor the point, but the subject case is one which gives this Honorable Court an opportunity to speak out and clearly define the consequences of the sale of a partnership interest. The divergence of opinion among the Courts of Appeal with regard to the aggregate and entity concepts should not continue. Because section 741 is in the 1954 Code all of the Courts of Appeal should apply the entity concept and give capital gains treatment to the entire sale. And only in those instances where an underlying asset fits into section 751 of the Code should the income therefrom be treated as ordinary income. And in those cases arising prior to 1954 where the Court is unable to fit the underlying asset into a Code provision then prevailing requiring that the income be treated as ordinary income (and the instant case falls into this category), the entire sale of the partnership interest should be given capital gains treatment.

II. The decision of the Court of Appeals is based on the fact that the selling partners retained an economic interest in the leases when the circumstances showed that the contract arrangements by which Petitioner received annual payments measured by the amount of sand and gravel produced from the properties conveyed was not such a retained economic interest in the sand and gravel as to make the income attributable thereto ordinary income subject to depletion, thereby resulting in a decision which is in conflict with decisions of this Court, and in conflict with decisions of other Courts of Appeal.

The Court of Appeals should have followed the established precedent and held that this was a sale of a partnership interest and that the gain or loss from the sale be treated as capital gain or loss. The Court of Appeals took a contrary approach and considered the sand and gravel leases which were sold as a separate and distinct part of the transaction. Even pulling the sand and gravel leases involved in this transaction out of the category of being a part of an entire sale and examining them separately, leads to the inescapable conclusion that under the decided cases this was the sale of a capital asset entitled to capital gains treatment.

In the Court of Appeals the Respondent urged that the partners had an economic interest in the sand and gravel in place under the leases, and since their income after transfer of the leases depended solely upon production and sale of sand and gravel, the partners retained an economic interest to that extent. In reply to this the Petitioner contended that under the circumstances prevailing in this case, the contract arrangements by which Petitioner received annual payments measured by the amount of sand and gravel produced from the properties conveyed (until they had received the sum of $1,000,000.00) was not such a retained economic interest in the sand and gravel as to make the income attributable thereto ordinary income subject to depletion.

The Court of Appeals went along with the contention of the Respondent in the following:

> "But in unmistakable language that simply could not be made more positive, the conveyance — all of the documents read together — kept back, that is reserved and excepted from the transfer, so much of the minerals as was necessary to make up the $1 million payment. The transfer is something less than *all*, it is something less than the whole. As we many years ago said: '* * * the real essence of the transaction was that the lease was sold and all the oil *except* that whose proceeds were to come to the selling taxpayer. * * * The thing sold for the cash consideration was the lease and all the oil except that so reserved.' Commissioner v. Fleming, 5 Cir., 1936, 82 F. 2d 324 at 327. (emphasis in the original). See also Miller, Oil and Gas Federal Income Taxation (3rd ed. 1957), p. 182." (C.A. Op. *infra*, p. 11a)

In a series of decisions beginning with *Palmer* v. *Bender*, 287 U. S. 551 (1933), 53 S. Ct. 225, this Honorable Court has established the principles governing the tax consequences of disposition of natural resources. The cases decided subsequent to the *Palmer* case include *Anderson* v. *Helvering*, 310 U. S. 404 (1940), 60 S. Ct. 952; *Burton-Sutton Oil Company* v. *Commissioner*, 328 U. S. 25 (1946), 66 S. Ct. 861; *Commissioner* v. *Southwest Exploration Company*, 350 U. S. 308 (1956), 76 S. Ct. 395. Under these decisions, notwithstanding the terminology of the contract, the transaction is to be treated as a sale if the consideration is payable to the grantor who has not retained an economic interest in the resource in place and whose payment is not determined by the production and sale of the property sold. On the other hand, regardless of the wording of the contract, if the consideration payable to grantor is paid out of the extraction and sale of the mineral, the owner is said to retain an economic interest, and therefore his proceeds

from the transaction are to be reported as ordinary income subject, under certain conditions, to a depletion deduction.

While most of the body of the law has been developed in oil and gas cases, six recent sand and gravel cases have dealt with these principles; *Crowell Land & Mining Corporation* v. *Commissioner*, 242 F. 2d 864 (CA-5, 1957); *Giovans* v. *Commissioner*, 246 F. 2d 448 (CA-9, 1957); *Albritton* v. *Commissioner*, 248 F. 2d 49 (CA-5, 1957); *Barker* v. *Commissioner*, 250 F. 2d 195 (CA-2, 1958); *Bel* v. *U. S.*, 160 F. Supp. 360 (D.C., La., 1958); *Linehan* v. *C.I.R.*, 297 F. 2d 276 (CA-1, 1961).

In the *Crowell* case, Crowell, as vendor, sold and conveyed to the vendee all the sand and gravel underlying described property. Consideration was fifteen cents per cubic foot for all sand and gravel removed, payable $1200.00 upon execution of the instrument and $1200.00 at the beginning of each year the contract was in effect. The vendee had the privilege of removing without additional payment up to $1200.00 of sand and gravel each year. All sand and gravel removed over and above the advanced payment was payable monthly at the contract rate. Failure to make any payment cancelled the contract. Vendee had five (5) years in which to remove the sand and gravel, after which time any remaining sand and gravel reverted to Crowell. The Court determined that the Tax Court had erred in determining that the vendor retained an economic interest, because the payments were to be made as the deposits were removed over a five-year period, with a reversion of the properties to vendor. The Court determined that the transaction was a sale, that the instrument undertook to convey the entire interest in the sand and gravel, and expressed the intent to make a bona fide sale. In looking at the actual circumstances, as well as the language of the contract of sale, the

Court stated there was no occasion or basis of resorting to legal niceties of interpretation to defeat the basic purposes and effect of the transaction. The Court pointed out that the provision for reverter and retransfer at the end of five years did not detract from the instrument but was in the nature of a vendor's lien to protect the payment due. The Court concluded, stating:

> "Neither the method of payment, based upon the amount of the deposit removed at specified intervals during the five-year period the vendor had in which to effect removal, nor the provisions for reverter and retransfer can be regarded as indicia of or analogous to a mineral lease so as to permit the payments made by the vendee under the sales contract to be regarded and treated as payments of royalty rather than, as they were intended to be and were, installment payments on the price."

Two months later the *Gowans* decision held for the taxpayer in the face of similar contentions of the Commissioner. The payment for the black sand was referred to as "royalty" payment. In this case, in addition to removing the sand over a six-year period, after which the property reverted to Gowans, the sellers, the buyer was to fill and level the property, install streets and utilities, and build the sellers a house on one of the lots at a cost of $19,322.81. The buyer used the royalty payments to retire a note of the sellers and charged all payments on its books as "royalties." The Court stated that three factors seemed to be decisive. In the first place, the Court stated that the purpose of the contract from the petitioner's point of view was to prepare the property for development for a real estate subdivision and the exploitation of the natural sand deposits was presumably not an unwelcome feature of the arrangement. A purpose other than the economic exploitation of the de-

posits would indicate an economic interest was not retained. The second factor was that the buyer obligated itself to remove all of the sand. The third factor was that since the buyer obligated itself to remove all the sand, there was an obligation to pay for the sand which became a "fixed liability" to the buyer and, in addition, the sellers received substantial compensation in addition to the extraction of the sand and did not have to look solely to the extraction of the sand for their compensation.

In the *Barker* case the Tax Court was reversed. The agreement provided that the buyer was not required to remove any amount of sand or gravel, although $3,000.00 minimum quarterly payment would still be due. The Court found the parties intended a present passing of title. The payments were not royalties but a liquidation of the Buyer's obligation to pay for the sand and gravel. The fact that *Barker* would be benefited if no sand and gravel were removed did not prevent the transaction being a sale.

It is abundantly clear that the decisions in the *Crowell, Gowans* and *Barker* cases are decisive and control the instant case. There are many facts in the subject case which prove that the partners retained no economic interest. The main purpose of the instruments was to convey the entire business interest of the partners to the purchaser and not to provide the means for future development or exploitation of the sand and gravel leases. The partners did not retain any control or management over the future development of the sand and gravel leases. The buyers were under no obligation to develop the sand and gravel leases. The sales prices of the business was for a sum certain which did not depend on the profits derived from the sale of the sand and gravel deposits and was not computed in relationship to the profits to be derived from the sale of sand and gravel. The partners did not have to look to the extraction of the sand

and gravel as the only means of regaining their capital, as they received substantial compensation wholly unrelated to sand and gravel withdrawals or production. Although payment of part of the purchase price was to be based upon the rate of production of the sand and gravel deposits, there were sufficient other assets which the buyer could apply to the purchase price, if the buyer so desired, even though the sales instrument restricted the assets securing the purchase of the sand and gravel deposits. The payment of the purchase price out of the production from the sand and gravel leases was a plan of deferred or installment payment of the purchase price of the business. The reservation of a right to any released leases was a preservation of security for the payment of the purchase price and was in effect a vendor's lien. The sellers did not retain any interest, title or control over the sand and gravel deposits but merely based the payment of the purchase price on its rate of production. The interests of the seller ceased upon the payment of the purchase price. Together, the sand and gravel properties and the equipment and related assets of the business were of substantial value, while as individual and separate assets they were only of lesser value.

In accord with the *Crowell*, *Gowans* and *Barker* cases are the cases of *Bel* v. *U. S.*, 170 F. Supp. 360; *Robert M. Dann & Helen B. Dann*, 30 T.C. 499 (1958) appeal dismissed pursuant to stipulation; and *I. B. Griffith* v. *U. S.*, 180 F. Supp. 454 (D.C. Wyo., 1960), no appeal.

It is obvious that to permit the decision of the Court of Appeals to stand results in a conflict of that decision with the decision of that same Court in the *Crowell* case, and further a conflict with Ninth Circuit decision in the *Gowans* case and the Second Circuit decision in the *Barker* case. The most recent sand and gravel case which was decided by the First Circuit is *Linehan* v. *C. I. R.*, 297 F. 2d

276 (CA-1, 1961) which holds in accord with the *Crowell*, *Gowans* and *Barker* cases and is in conflict with the Court of Appeals decision in the instant case.

This brings Petitioner to the point of urging upon this Honorable Court its most careful and thoughtful consideration of the opinion written by Chief Judge Woodbury in the *Linehan* case. The *Linehan* case was an appeal from the decision of the Tax Court of the United States. The Tax Court opinion is found at 35 T.C. 533 and that opinion is referred to for a full and complete statement of the pertinent facts.

In the *Linehan* case the purchaser of the sand and gravel was given the exclusive "right to remove" sand and gravel. The same is true in this case for under the terms of the Conveyance and Agreement, Witte Gravel Company obtained the exclusive right to remove the sand and gravel. In *Linehan* the payment for the sand and gravel was at a fixed price per cubic yard. The same is true in this case for the Conveyance and Agreement provided specifically that Witte Gravel Company should receive 5¢ per ton on the first 300,000 tons of sand or gravel produced etc. (R. 114) In the *Linehan* case, the amount received by the taxpayers was not dependent on the price received in the sale of the sand and gravel by the purchasers thereof to a third party. The same is true in the subject case for regardless of what price Witte Gravel Company was able to get from the sale of the sand and gravel to a third party still the amount that the Petitioner received was set and determined and did not increase or decrease.

The rule is well established that where the taxpayer retains an economic interest in the assets then the proceeds from the transaction are to be reported as ordinary income subject, under certain conditions, to a depletion deduction. The decision of Chief Judge Woodbury in the

Linehan case spells out clearly the true meaning of this rule at page 278:

> "The allowance for depletion, which has long been recognized in the revenue laws, is based on the theory that the extraction of minerals gradually exhausts the capital investment in the mineral deposit. Commissioner v. Southwest Exploration Co., 350 U.S. 308, 312, 76 S. Ct. 395, 100 L. Ed. 347 (1956). Therefore, as the Court had previously pointed out in Kirby Petroleum Co. v. Commissioner, 326 U.S. 599, 603, 66 S. Ct. 409, 411, 90 L. Ed. 343 (1946), it follows from this theory '* * * that only a tax payer with an economic interest in the assets,' in that case oil 'is entitled to the depletion.' In this connection the Court pointed out that technical title to the deposit in place is not important, for that may depend upon the law of the state in which the property lies. 'Economic interest,' it said on the following page of its opinion in 326 U. S. at page 411 of 66 S. Ct., 'does not mean title to the oil in place but the possibility of profit from that economic interest dependent solely upon the extraction and sale of the oil.'
>
> "'Applying these general principles to the facts before it the court determined that the landowners — taxpayers were lessors who had an 'economic interest, a capital investment' in the oil after extraction by the persons to whom they had granted exploitation rights, not only because the parties were so dominated in the agreements but also because the consideration paid by the exploiters, called bonuses and royalties, was based upon the net profits accruing to them as a result of their operations. * * *'"

In the *Linehan* case Chief Judge Woodbury went further to consider the matter of the importance of calling a particular transaction a "sale" or a "lease" and concluded that the use of these words was *not* the determining factor, but

rather the determining factor was the "true substance" of the transaction:

> "* * * We do not gather from Kirby that decision in cases like this turns entirely upon whether a given transaction between a landowner and his grantee of the right to exploit mineral deposits on his land is technically a lease or a sale. Whether a given transaction is clearly one or the other may be indicative of the result but is not necessarily determinative. Indeed, should the test be whether a transaction is strictly speaking a 'sale' or a 'lease' we would be at a loss to know how to decide this case, for the contracts under consideration are in terms of 'right to remove.' They are not couched in terms of purchase and sale as in Crowell Land and Mineral Corp. v. Commissioner, 242 F. 2d, 864 (C.A. 5, 1957). Nor do the contracts describe the parties as lessor and lessee and denominate the remuneration given for the sand and gravel as royalty as in Albritton v. Commissioner, 248 F. 2d 49 (C.A. 5, 1957). But cases like this do not turn upon the use of words alone unless it is abundantly clear that the words used by the parties were chosen with precision and accurately reflect their intention and the 'true substance' of the transaction entered into between them. See Barker v. Commissioner, 250, F. 2d 195, 197 (CA-2, 1957)."

The language in the *Linehan* case which is so important here is that which follows immediately for it refutes completely the conclusion reached by the Honorable John R. Brown in the majority opinion of the Fifth Circuit Court of Appeals where he concluded that the ownership of the reserved $1,000,000. production payment remained in the Petitioner. The Honorable John R. Brown was concerned about the fact that to not apply the language of the Conveyance and Agreement literally would bring confusion into the oil and gas field, particularly where there had been court

decisions in which language like that contained in the Conveyance and Agreement had been construed. This conclusion by the Honorable John R. Brown is unfounded and can be overlooked completely when the language of the *Linehan* case is analyzed fully and completely and particularly the following:

> "Turning then to the 'true substance' of the transactions between this taxpayer and those to whom he gave the right to remove sand and gravel from his property, it is evident that the taxpayer had no 'economic interest' in the material taken from his property after its severance, for in every instance he sold sand and gravel for fixed prices per cubic yard without reference to the prices received or the profits, if any, made by the exploiters."

All of the cases cited by the Court of Appeals in support of its decision are clearly distinguishable from the subject case. The cases of *Albritton* v. *Commissioner*, 248 F. (2d) 49 (CA-5, 1957); *Lee* v. *Commissioner*, 126 F. 2d 825 (CA-5, 1942); *Commissioner* v. *Williams*, 82 F. 2d 328 (CA-5, 1936); *Thomas* v. *Perkins*, 301 U. S. 655, 57 S. Ct. 911; 81 L. Ed. 1324 are cited by the Court and a careful consideration of them shows that they are not controlling of the subject case.

Unlike those cases, the instruments here transfer the sand and gravel properties, grants, bargains, sells, transfers, assigns, sets over and delivers to the purchaser *all* of the interests of the partners in the sand and gravel properties. The purchaser is under no obligation to mine the sand and gravel, but only is to give the partners notice if it intends to cancel, surrender or relinquish any of the sand and gravel properties. Inasmuch as the sand and gravel properties are the security for one million dollars of the purchase price of the partnership, this provision serves to enable the Petitioner to protect any part thereof which

may be unpaid. As the court pointed out in the *Crowell* case, the provisions for reverter or retransfer did not detract from the instrument but was in the nature of a vendor's lien to protect the payment due.

Unlike the *Albritton* case where the lessors received a certain percentage of the retail value of the sand and gravel removed during operations under the lease, the Petitioner in our case, as the sellers in the other sand and gravel cases, received a fixed amount per measurement (cubic yard or ton) for the sand and gravel produced from the properties, said amount having no relation whatsoever to the profits realized by the purchaser.

The Court of Appeals would make much of the fact that the payments were labeled "a limited overriding royalty interest or production payment" and that the purchaser considered and called the payments "overriding royalties" on its books and records. This very issue was raised in the *Gowans* case but there the Court proceeded to analyze the whole transaction and found no retained economic interest. See also Louisiana Revised Civil Statutes, Sections 1949, 1950, 1955 and 1959.

Although the instrument in our case refers to the payments to be made to the Petitioner as "limited overriding royalty interest or production payment," the very terms and provisions for the payments in the instrument prevent the payments from being of such a nature. Instead, the payments are in fact of the same nature as the payments in the other sand and gravel cases, that is, payments of a stipulated amount per unit. As the Court concluded in the *Crowell* case (which was followed in the other cases), the method of payment, based upon the amount of the deposit removed at specified intervals cannot be regarded as indicia of ownership to a mineral lease so as to permit the payments made by the vendee under the sales contract to be regarded and treated as payments of royalty rather than,

as they were intended to be and were, installment payments on the price.

In considering the whole transaction, it is apparent, as it was in the *Gowans* case, that the primary purpose of the transaction was not the exploitation of the sand and gravel deposits but the sale of a going business, and as the Court stated in the *Gowans* case, this would be indicative of a retained economic interest.

Petitioner respectfully urges that the decision of the Honorable Edwin F. Hunter, Jr. (joined in by the Honorable Warren L. Jones of the Fifth Circuit in his dissenting opinion) is the correct decision, and his appraisal of the facts led him to conclude that there was no retained economic interest:

> "Plaintiffs were not entitled to receive or be credited with any part of the material removed. The rise or fall in sand and gravel prices would not affect the price to be paid to them. Plaintiffs, within the meaning of the cases, did not retain an economic interest in the sand and gravel properties." (R. 121)

CONCLUSION

For the foregoing reasons, it is respectfully submitted that this petition for writ of certiorari should be granted.

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CERTIFICATE OF SERVICE

I, Peter B. Wells, one of the attorneys for Raymond H. Witte and Lillian B. Witte, petitioners herein, and a member of the Bar of the Supreme Court of the United States, hereby certify that on the 19th day of October, 1962, I served copies of the foregoing Petition for Writ of Certiorari on United States of America, Respondent, by mailing copies in duly addressed envelopes with first class postage prepaid to The Solicitor General, Department of Justice, Washington 25, D. C.; T. Fitzhugh Wilson, United States Attorney, Shreveport, Louisiana; Louis F. Oberdorfer, Assistant Attorney General, Department of Justice, Washington 25, D. C.

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Peter B. Wells
Attorney for Petitioners

APPENDIX A

IN THE

United States Court of Appeals

FOR THE FIFTH CIRCUIT

No. 19,129

UNITED STATES OF AMERICA,
Appellant,

versus

RAYMOND H. WITTE and LILLIAN B. WITTE,
Appellees.

APPEAL FROM THE UNITED STATES DISTRICT COURT FOR THE WESTERN DISTRICT OF LOUISIANA

(July 25, 1962)

Before JONES, BROWN and BELL, Circuit Judges.

BROWN, Circuit Judge: The question here is whether proceeds generated by the transfer of sand and gravel leases constituted capital gain or ordinary income subject to depletion under the 1939 Code. As tried below and argued generally here, this turned ostensibly on whether the transfer amounted to an outright sale, or whether it had some lesser status analogous to a lease or sublease so that the transferor is deemed to have an economic interest in all or a part of the thing transferred. This approach of a lease, which we regard as erroneous on this record, led both parties to other interesting and perhaps troublesome subsidiary

problems which, as we view it, really have nothing to do with the case and its proper disposition.

The District Court, on a record consisting primarily of a stipulation as to the underlying facts and the authenticity of the transfer documents and conveyances and supplemented only by brief oral testimony of the Taxpaper concerning some physical attributes of the property and that of his lawyer asserting now that the aim was to achieve capital gains, held for the Taxpayer. The Trial Court's theory was that it was all one package with the objective being to sell an entire going gravel business so that all proceeds, no matter how characterized in the conveyances or when or how received, were a part of the consideration of the sale, and therefore constituted capital gains. The Government appeals. We hold that the Government is correct and reverse. We do it on the basis that the proceeds in question came from a production payment expressly reserved by the Taxpayer as grantor. By it the Taxpayer had an economic interest, and the proceeds are universally considered ordinary income subject to depletion.

Though we disagree with the decision of the District Court and reject either as irrelevant or unsupported, so-called fact findings thought to be crucial, we refer to the comprehensive opinion of the District Judge which makes it unnecessary for us to state the facts in great detail. *Witte* v. *United States*, W.D. La., 1960, 201 F. Supp. 525.

Taxpayer and his two partners owned a going, thriving sand and gravel business in Louisiana. The partnership had ascertained that its machinery and equipment, such as drag lines, bulldozers, tractors, clam shell buckets, pumps, conveyor belts, hydraulic dredges, workboats and similar plant was well worth 1 million dollars. Test bores indicated that under leases, mining agreements, ownership of sand in place or similar agreements with various third party land-

owners, the partnership had under effective ownership reserves of at least 40 million tons of sand and gravel of which at least 60% (24 million tons) was commercially recoverable. The value was, they concluded and no one now disputes, of a value well in excess of 1 million dollars. After negotiations with the Murchinson interests of Dallas, Texas, the partners agreed to sell. To exploit existing good will, the purchaser was to be a new Delaware corporation, Witte Gravel Company, and the Taxpayer was to (and did) continue actively in the new Company's management for several years.

Before discussing the mechanics of the transfer, it simplifies things considerably to eliminate at the outset the controversy with which each of the parties has been so preoccupied below and here. The Government, on the one hand, insists that it must be fragmented into a series of separate isolated agreements with each paper bearing its own legal consequences without regard to any other. The Taxpayer, on the other hand, asserts that this was the sale of an entire going business so that it should be looked at as the sale of a partnership business.[1] To this the Government rejoined in the words of *Williams v. McGowan*, 2 Cir., 1945, 152 F. 2d 570, 572, that "upon the sale of a going business it is to be comminuted into its fragments," so that the gain on each fragment is characterized as capital gain or ordinary income as the case might be.[2] But as we recently pointed out,

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[1] Taxpayer cites principally Hatch's Estate v. Commissioner, 9 Cir., 1952, 198 F. 2d 26; Hamilton A. Gray, 11 T.C.M. 17, DKT. 30148 (1952); and 6 Mertens, Law of Federal Income Taxation §35.55, at 166-67.

[2] As countervailing Hatch's Estate, supra, and others, it urges the Supreme Court's decision in Watson v. Commissioner, 1953, 345 U.S. 544, 73 S. Ct. 848, 97 L. Ed. 1232, as well as in Choate v. Commissioner, 1945, 324 U.S. 1, 65 S. Ct. 469, 89 L. Ed. 653, which resolved the conflict between the 10th Circuit and this Court's decision in Hogan v. Commissioner, 5 Cir., 1944, 141 F. 2d 92, cert. denied, 323 U.S. 710, 65 S. Ct. 36, 89 L. Ed. 571.

this Court has long rejected the aggregate theory and has followed the entity concept in determining the tax consequences in the sale of a going business. *Sherlock* v. *Commissioner*, 5 Cir., 1961, 294 F. 2d 863.

For reasons we later discuss, this initial intramural contest is of no consequence. But we entertain no doubt that the Taxpayer is right that this was, and has to be, regarded as a single transaction in which a going business enterprise was being transferred to entirely new ownership.[3] Consequently each paper, document, or conveyance, while important and enforceable in accordance with its own terms, is not to be looked upon as an isolated thing. All are to be treated as part and parcel of a continuous comprehensive transaction. But for the reasons we later point out, this is far from agreeing with Taxpayer that the cash payable ($578,550.53) and the production payment ($1,000,000) are to be aggregated as though the purchase price was declared to be $1,578,550.53.

To effectuate the sale, four separate documents were used: a bill of sale, a promissory note, a chattel mortgage, and a mineral (sand and gravel) conveyance. Only this mineral conveyance gives rise to the problem. The bill of sale, the promissory note, and the chattel mortgage were all complementary. They were concerned solely with the equipment being transferred. For this equipment the purchaser agreed to pay $578,550.53.[4] All were effective as of January 1, 1953.

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[3] The bill of sale covering the equipment and the separate mineral (sand and gravel) conveyance each contained a carefully drafted 15-year covenant not to compete. This negatives the idea, implicit in the Government's approach, that each step must be separately viewed. In addition, a number of legitimate non-tax business factors made use of multiple documents advisable.

[4] No question has been raised as to allocation or basis, either alone or in connection with the minerals, production payment or the

Simultaneously Taxpayer and his partners executed the "conveyance and agreement" by which, "for a valuable consideration which Assignee has * * * paid * * *," the Assignors "do hereby grant, bargain, sell, transfer, assign, set over and deliver" eight specified "instruments of lease and/or instruments of sale and conveyance" of sand and gravel properties. The assignment was effective as of 7:00 o'clock a.m. January 1, 1953 and provided that "All * * * operating expenses incurred and accrued from and after such date and hour shall be borne and paid by Assignee and Assignee is hereby granted and shall be entitled to receive all income and proceeds * * * from the sale * * * of sand, gravel, * * * produced * * * or disposed of * * * after such date and hour." But immediately following these granting provisions, the conveyance provided that:[5]

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like. The promissory note in that sum was payable in fixed installments over four years ending in January 1957. The chattel mortgage executed by the Purchaser secured the payment of this note.

[5] "* * *, there is by Assignors excepted from this assignment and expressly reserved unto themselves and their respective heirs, representatives and assigns, in equal one-third (1/3) shares, as a limited overriding royalty interest or production payment that shall be delivered to the credit of Assignors, * * * an undivided fractional percentage of all sand and/or gravel, in, on or under and to be produced, saved and sold from the lands * * *, covered by the above-described instruments * * * sufficient to yield, * * * the full net sum of One Million Dollars ($1,000,000.00); * * * Said limited overriding royalty or production payment shall be payable out of the proceeds of the sale of sand and/or gravel, and only out of same and not otherwise, as follows:

"(a) Five cents (5¢) per ton on the first 300,000 tons of sand and/or gravel produced, saved and sold from the above described premises or any part of them * * * in each particular year beginning January 1, 1953, and ending December 31, 1956, plus ten cents (10¢) per ton on all tons of sand and/or gravel produced, saved and sold in excess of 300,000 tons from said premises in any such particular year during such four-year period, and from and after January 1, 1957, ten cents (10¢) per ton on all tons of sand and/or gravel

"There is by Assignor excepted from this assignment and expressly reserved unto themselves and their respective heirs * * *, as a limited overriding royalty interest or production payment * * *, an undivided fractional percentage of all sand and/or gravel * * * produced * * * from the lands * * * sufficient to yield * * * the full net sum of One Million Dollars ($1,000,000) * * *."

The conveyance went on to provide the manner and rate per unit for the satisfaction of this production payment. It

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produced, saved and sold from such premises * * * until from all of same Assignors shall have received the full net sum of Seven Hundred Fifty Thousand Dollars ($750,000.00); and

"(b) Thereafter, * * * two cents (2¢) per ton on all tons of sand and/or gravel produced * * * until Assignors shall have received the full net um of Two Hundred Fifty Thousand Dollars ($250,000.00).

"Accounting for, and payments accruing to Assignors under * * * such retained limited overriding royalty or production payment shall be made quarterly * * * with the * * * payments to be made to Assignors not later than twenty (20) days after each such accounting period.

"* * *

"It is understood and agreed that Assignee, its successors and assigns, shall never be personally liable for the payment of the amount of the aforesaid limited overriding royalty interest or production payment, or any part thereof, and that Assignors, * * * shall look exclusively to the sand and/or gravel herein reserved to them for the payment thereof and that Assignors, * * * shall have no lien or other security whatsoever for the payment of said limited overriding royalty interest or production payment, * * *.

"It is further understood that upon the Assignors having received from the proceeds of sale of sand and/or gravel attributable to said reserved and retained interest the total sum thereof, * * * $1,000,000.00, then all rights, titles and interests herein reserved by the Assignor shall absolutely terminate and thereupon the fractional interest so reserved * * * shall vest absolutely in Assignee * * * and assigns, free and clear of the exception and reservation herein made, and to evidence such fact, Assignors * * * will thereafter * * * execute and deliver on request all necessary or appropriate acquittances."

excluded positively any personal liability on the purchaser for the production payment and likewise excluded any lien or security of any kind save the sand and gravel for the satisfaction of the production payment.

Finally, it was provided that when Taxpayer had received the full $1,000,000 from the reserved and retained interest in the sand and gravel, then all rights and titles reserved by the Taxpayer "* * * shall absolutely terminate and thereupon the fractional interest so reserved for the payment thereof shall vest absolutely in Assignee * * * free and clear of the exception and reservation * * *."

It is the proceeds of the production payment received in the tax year 1953 and 1954 that is in dispute. The Commissioner determined that this represented an economic interest retained in the property sold and consequently was taxable as ordinary income subject to percentage depletion. The District Court in the tax refund suit held, in substance, that this was a sale of an entire going business, and that the amounts received (or to be received in future years) from the production payment was merely an installment arrangement for a deferred payment of the purchase price. Therefore, the Court concluded, the whole $1,578,550.53 was subject to capital gain.

Much of the trial Court's difficulty came, we think, from quibbling by counsel over whether the mineral (sand and gravel) conveyance was a lease with a royalty reserved or a sale. This is what has occupied the attention of the courts in cases from this and other Circuits in sand and gravel situations.[6] Equally fallacious was the Government's argu-

[6] Those primarily urged by Taxpayer are: Crowell Land & Mineral Corp. v. Commissioner, 5 Cir., 1957, 242 F. 2d 864; Gowans v. Commissioner, 9 Cir., 1957, 246 F. 2d 448; Barker v. Commissioner, 2 Cir., 1957, 250 F. 2d 195; Linehan et al. v. Commissioner, 1 Cir., 1961, 297 F. 2d 276. The Government stresses our decision in Albritton v. Commissioner, 5 Cir., 1957, 248 F. 2d 49, in which an opposite result was reached.

ment presumably advanced below, and certainly renewed here, that all Taxpayer had under the sand and gravel conveyances into him was the equivalent of a mere "lease" interest. Consequently, the argument runs, the transfer could not give rise to capital gains since a lease cannot be the subject of a sale. Of course it can.[7] And if sold, the proceeds for the interest sold are treated as capital gains.

This conceptual confusion is of more than academic interest. It was, we think, the thing which diverted all from facing up to the real problem. The problem was not whether there was a sale. Of course there was. The problem is *what* was sold?

On the face of these documents — undiminished in any respect by the brief testimony of Taxpayer and his regular counsel — two things were irrevocably sold:

(1) All of the equipment, plant and machinery without limitation of any kind; and

(2) (a) All of the sand/gravel owned by, or under lease to, Taxpayer *except*

(b) that which was reserved in the $1 million production payment.

The ownership of (2) (b) remained in Taxpayer. With respect to the sand/gravel out of which the production payment would be satisfied at the unit prices and times specified, the only change was that the cost of removal, processing and sale was now on the purchaser. The production payments — in lieu of the units of sand/gravel in kind — were to be free of any development costs. This illustrates why a production payment, or an oil payment, or a gas pay-

[7] We have said so plainly. "But a lessee's interest is everywhere regarded as vendible real property, and the lessee may sell his lease or an interest in it * * *." Commissioner v. Fleming, 1936, 5 Cir., 82 F. 2d 324 at 327; see Miller, Oil and Gas Federal Income Taxation (3rd ed. 1957), p. 73.

ment, or here a sand/gravel payment, is frequently referred to as a limited overriding royalty, just as it was described in the conveyance here involved.[8] (See note 5, supra).

It is precisely here where the District Court, by the preoccupation of counsel[9] with lease-versus-sale, was led into its basic error. Interwoven through the Court's opinion were repeated statements, based on a consideratio. of the whole transaction, that it was not merely "the exploitation of sand and gravel deposits, but the sale of a going business" and

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[8] Thus Breeding and Burton, Income Taxation of Oil and Gas Production (2nd ed. 1961), a recognized treatise in this field, defines these terms:

> § 2.05 Overriding royalty. "An overriding royalty is similar to a royalty in that, for federal tax purposes, each is a right to oil and gas in place that entitles its owner to a specified fraction of production, in kind or in value, and neither is burdened with the costs of development or operation. They differ in that an overriding royalty is created from the working interest from which it was created.
>
> "The overriding royalty may be carved out or retained."
>
> § 2.07 Production payment. "A production payment, for federal tax purposes, is a right to oil and gas in place that entitles its owner to a specified fraction of production for a limited time, or until a specified sum of money (which may be determined by a formula) or a specified number of units of oil or gas has been received. A production payment, or, as it is more commonly called, a gas payment or an oil payment, is somewhat like an overriding royalty, but, because it is definitely limited in amount and expires when this amount has been paid, different tax consequences attend its creation and disposition (as explained in Chapter 6)."

[9] The fallacious reasoning of the Government in failing to distinguish between that which is transferred and that which is not (see note 10, infra) is carried forward in its brief here. Thus the brief states: "* * * an oil payment right (also called a 'production payment'), and a net profits interest are all economic interests in the mineral in place which, when retained upon the execution or assignment of a lease, preclude the *transaction* from constituting *a sale*. Palmer v. Bender, supra; Thomas v. Perkins, supra; Kirby Petroleum Co. v. Commissioner, * * *; Burton-Sutton Oil Co. v. Commissioner * * *; see also Commissioner v. Southwest Expl. Co. * * *." (Emphasis added).

"the transaction" was found "to be a sale of the sand and gravel in place, and not a lease." This conclusion was, of course, sound had it stopped there. For it was, without a doubt, a sale.[10] But the Court, apparently thinking that if it was not a lease — as it most assuredly was not — then concluded that since the transaction was a sale, it was necessarily the sale of all. Thus with its own italicized emphasis, the Court stated, "Unlike Albritton[11] the instrument here transfers the sand and gravel properties and sets over and delivers to the purchaser *all* of the interest of the [Taxpayers] therein * * *. Here, unlike all the other cases[11] there is no fee title remaining in [Taxpayers]." And, reiterating that the "* * * parties intended to transfer everything that

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[10] The distinguishing element is whether any interest is retained in the part sold. One writer phrases it this way.

"The principal distinction between a lease of an oil property and a sale of the property is that in a lease of the property, a royalty interest is retained; in a sale of the property *no* interest is *retained* in the *portion* sold." (emphasis added) Fiske, Federal Taxation of Oil and Gas Transaction § 9.11 (1958).

The analysis of Breeding and Burton, Income Taxation of Oil and Gas Production (2nd ed. 1961), is helpful. The basic distinction is set forth in § 3.02. "A transaction will be classified as a lease * * * where the owner of operating rights assigns all or a portion of such rights * * * and retains a *continuing*, nonoperating interest in production." Thus, they point out in § 3.03, the transaction is a sale, not a lease, "When the owner of any kind of continuing property interest assigns that interest and retains a *noncontinuing* interest in production." Amplifying this, the text further states: "The only type of property or economic interest which is *noncontinuing* is the oil payment, because its life is limited in duration. Hence the third type of sale * * * transaction is one where the assignor retains an oil payment upon the assignment of a continuing interest in a property for cash or other property * * *. The interest assigned can be a working interest, a royalty, or an overriding royalty, because each is a *continuing* interest in the property; in this class of sale transaction it is not material whether the interest assigned is an operating or nonoperating interest." (emphasis supplied)

[11] The Court was referring to the cases listed in note 6, supra.

they owned in the partnership * * *," the Court concluded that Taxpayer "did not have a retained share or interest in the property itself * * *." 201 F. Supp. 525 at 531.

But in unmistakable language that simply could not be made more positive, the conveyance — all of the documents read together — kept back, that is reserved and excepted from the transfer, so much of the minerals as was necessary to make up the $1 million payment. The transfer is something less than *all*, it is something less than the whole. As we many years ago said, "* * * the real essence of the transaction was that the lease was sold and all the oil *except* that whose proceeds were to come to the selling taxpayer. * * * The thing sold for the cash consideration was the lease and all the oil except that so reserved." *Commissioner* v. *Fleming*, 5 Cir., 1936, 82 F. 2d 324 at 327. (emphasis in the original). See also Miller, Oil and Gas Federal Income Taxation (3rd ed. 1957), p. 182.

Of course, as we have many times held in analogous situations of an oil or gas payment, a production payment is an economic interest[12] as that term has generally come to be

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[12] In Lee v. Commissioner, 5 Cir., 1942, 126 F. 2d 825, we affirmed the decision of the Board of Tax Appeals which described it this way.

> "It seems clear from this language that the Supreme Court regards any oil payment right (a right to a specified sum of money payable only out of a specified percentage of oil or the proceeds received from the sale of such oil, if, as, and when produced) as an economic interest in oil in place, the holder thereof being the owner of the share of gross income from production represented by the payments to him and being entitled to the attending depletion allowance." 42 B.T.A. 1217, —.

We made immediate application of this in Commissioner v. Williams, 5 Cir., 1936, 82 F. 2d 328, 329:

> "The Respondent retained an economic interest in the oil, in place, in that his right to receive his share of the stipulated

understood.[13] As such, the proceeds are treated as ordinary income subject to depletion. *Thomas* v. *Perkins*, 1937, 301 U. S. 655, 57 S. Ct. 911, 81 L. Ed. 1324; *Lee* v. *Commissioner*, 5 Cir., 1942, 126 F. 2d 825; Miller, Oil and Gas Federal Income Taxation, (3rd ed. 1957), p. 51; Fiske, Federal Taxation of Oil and Gas Transactions §§ 2.09, 14.07 (a) (1958).

The transaction here was the precise application of the classic production payment device. Developed and approved in a succession of court decisions primarily in the oil and gas field, it has come to be a vital and important part of that business. Its advantages and benefits flow in many directions, to sellers and buyers, to financiers and investors, and to the revenue Commissioner whose apparent loss one

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deferred payment of $192,500 was dependent upon that amount being realized from oil produced. * * *."

See also Miller, Oil and Gas Federal Income Taxation (3rd ed. 1957), pp. 19, 51, 176-76, 182, 184; and Fiske, Federal Taxation of Oil and Gas Transactions §§ 2.09, 14.07 (a) (1958).

It is immaterial whether the interest retained is a right to a share in the mineral in kind or to share in the proceeds of the sale of the mineral produced. Miller, Oil and Gas Federal Income Taxation (3rd ed. 1957), pp. 21, 175; Commissioner v. Williams, 5 Cir., 1936, 82 F. 2d 328, 329.

[13] The formula was verbalized as early as Palmer v. Bender, 1933, 287 U.S. 551, 557, 53 S. Ct. 225, 77 L. Ed. 489:

> "The language of the statute is broad enough to provide, at least, for every case in which the taxpayer has acquired, by investment, any interest in the oil in place, and secures, by any form of legal relationship, income derived from the extraction of the oil, to which he must look for a return of his capital."

Almost without change it has been repeated in Thomas v. Perkins, 1937, 301 U.S. 655, 57 S. Ct. 911, 81 L. Ed. 1324; Kirby Petroleum Co. v. Commissioner, 1946, 326 U.S. 599, 66 S. Ct. 409, 90 L. Ed. 343; Anderson v. Helvering, 1940, 310 U.S. 404, 60 S. Ct. 952, 84 L. Ed. 1277; Burton-Sutton Oil Co. v. Commissioner, 1946, 328 U.S. 25, 66 S. Ct. 861, 90 L. Ed. 1062, and down through the most recent, Commissioner v. Southwest Exploration Co., 1956, 350 U.S. 308, 76 S. Ct. 395, 100 L. Ed. 347.

day may be a gain the next.[14] Thus, while the District Court undertook to declare as a fact that the production payment was really nothing but a device for a deferred payment of the purchase price, there is no evidence to support this. Certainly this is true from the standpoint of the purchaser. For there is no indication that the purchaser would have been willing to pay the $1 million in tax-paid dollars. A moment's reflection, in the light of pervasive income taxes, would readily demonstrate that the trade, from the purchaser's standpoint, would necessarily have been different. It is not, however, one-sided. The purchaser reaps undoubted advantages. But it is those advantages which make purchase and acquisition in this way attractive. And this, in turn, may just as often benefit the seller. Of course it is of no concern to us whether the mechanism affords one, or the other, or both advantages or disadvantages. But with the tax, and hence economic-business consequences of this method being so well known and established, we ought

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[14] The practical tax and business advantages of a sale by A (the seller) to B (the buyer) with a retained production payment is described by Breeding and Burton, Income Taxation of Oil and Gas Production (2nd ed. 1961):

§ 5.10. "To accomplish this result, B has, of course, given up a substantial share of the production, but he has gained another material advantage. The production going to satisfy the production payment does not constitute taxable income to B, and in effect he pays for the property from income before taxes. The advantage becomes clear if the above described result is compared with B's situation if he had bought the entire property with borrowed funds * * *. He would then receive the oil proceeds which would otherwise have been paid to the oil payment owner, but these proceeds would increase B's taxable income. * * * The advantage in this type of arrangement does not all rest with the purchaser of the property. A, the seller, may also get a better price for his property by making it possible for the buyer to obtain the property under more favorable tax circumstances."

See also Fiske, Federal Taxation of Oil and Gas Transactions § 14.03 (1958).

to weigh carefully any importunities to read into this total transaction something which is not there. Certainty is so seldom obtainable. We ought not to make uncertainty. The production payment is certain in its application and tax consequences. Uncertainty in a transaction so precisely constructed as this one was ought not to be imported on anything as equivocal as that urged here — the misplaced hope of Taxpayer that the transaction was to be treated as a capital gain.

Indeed, the transaction was perfectly constructed for capital gain, and to achieve them all that Taxpayer had to do was to sell the production payment.[15]

The production payment was owned by Taxpayer. With great precision it was made positive that Taxpayer had to look solely to the minerals or their proceeds for the satisfaction of this payment. The requirements of *Anderson* v. *Helvering*, 1940, 310 U.S. 404, 60 S. Ct. 952, 84 L. Ed. 1277, were scrupulously observed. The proceeds, when and as received by Taxpayer, were the return of his own capital

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[15] The production payment retained by A, the seller, may be sold to C as an isolated unplanned, subsequent transaction and when sold it constitutes capital gains. "If the sale of the oil payment divests the seller of all interest in the property, capital gain will be recognized. Thus A, owning an oil lease, may sell the working interest to B, retaining an oil payment, and then sell the oil payment to C. A has divested himself of the entire lease and gets capital gain on both sales." Fiske, Federal Taxation of Oil and Gas Transactions (1958) at 131.

Another approach concerning which there is a considerable body of tax literature is the more intricate structure of the so-called ABC deal. This is discussed in Appleman, The ABC Deal, 11th Oil & Gas Inst. 519 et seq. (S.W. Legal Fdn. 1960), and which lists, note 2, a number of articles on the subject; also Fiske, Federal Taxation of Oil and Gas Transactions § 14.03 (a), (1958), (note 5 listing articles); Miller, Oil and Gas Federal Income Taxation (3rd ed. 1957), pp. 204-205 (artilces note 78); and Breeding and Burton, Income Taxation of Oil and Gas Production § 5.10 (2nd ed. 1961).

investment in a depletable mineral. Such proceeds constitute ordinary income subject to depletion. The Government was right and the judgment should have been in its favor.

REVERSED AND RENDERED.

JONES, Circuit Judge, Dissenting:

I am unconvinced, by the opinion of the majority or otherwise, that the determination of this case by the district court was erroneous. *Witte* v. *United States*, 201 F. Supp. 525.

A true copy

Test: EDWARD W. WADSWORTH
Clerk, U. S. Court of Appeals, Fifth Circuit

By G. F. GANUCHEAU
Deputy

New Orleans, Louisiana Oct. 10, 1962

[SEAL]

APPENDIX B

United States Court of Appeals

FOR THE FIFTH CIRCUIT

October Term, 1961

No. 19,129

D. C. Docket No. 7421 Civil

UNITED STATES OF AMERICA,

Appellant,

versus

RAYMOND H. WITTE and LILLIAN B. WITTE,

Appellees.

APPEAL FROM THE UNITED STATES DISTRICT COURT FOR THE WESTERN DISTRICT OF LOUISIANA

Before JONES, BROWN and BELL, Circuit Judges.

JUDGMENT

This cause came on to be heard on the transcript of the record from the United States District Court for the Western District of Louisiana, and was argued by counsel;

ON CONSIDERATION WHEREOF, It is now here ordered and adjudged by this Court that the judgment of the said District Court in this cause be, and the same is hereby, reversed and rendered in favor of the Government.

"Jones, Circuit Judge, Dissents."

(July 25, 1962)

Issued: September 5, 1962

APPENDIX C

Internal Revenue Code of 1939 — Section 117 (26 U.S.C.A., 1952 ed. Sec. 117):

"(a) (1) The term "capital assets" means property held by the taxpayer (whether or not connected with his trade or business) * * *

"* * *

"(4) The term "long-term capital gain" means gain from the sale or exchange of a capital asset held for more than 6 months, if and to the extent such gain is taken into account in computing gross income; * * *"

Note: In view of the length of Sec. 117 the other provisions are not printed, but by reference said Sec. 117 in its entirety is incorporated herein.

Internal Revenue Code of 1954 — Section 741 (28 U.S.C.A., 1958 ed. Sec. 741):

In the case of a sale or exchange of an interest in a partnership, gain or loss shall be recognized to the transferor partner. Such gain or loss shall be considered as gain or loss from the sale or exchange of a capital asset, except as otherwise provided in section 751 (relating to unrealized receivables and inventory items which have appreciated substantially in value). Aug. 16, 1954, 9:45 A.M., E.D.T., c. 736, 68A Stat. 248.

Internal Revenue Code of 1954 — Section 751 (28 U.S.C.A., 1958 ed. Sec. 751):

(a) Sale or exchange of interest in partnership. — The Amount of any money, or the fair market value of any property, received by a transferor partner in exchange for

all or a part of his interest in the partnership attributable to —

(1) unrealized receivables of the partnership, or

(2) inventory items of the partnership which have appreciated substantially in value,

shall be considered as an amount realized from the sale or exchange of property other than a capital asset.

(b) Certain distributions treated as sales or exchanges. —

(1) General rule. — To the extent a partner receives in a distribution —

(A) partnership property described in subsection (a) (1) or (2) in exchange for all or a part of his interest in other partnership property (including money), or

(B) partnership property (including money) other than property described in subsection (a) (1) or (2) in exchange for all or a part of his interest in partnership property described in subsection (a) (1) or (2),

such transaction shall, under regulations prescribed by the Secretary or his delegate, be considered as a sale or exchange of such property between the distributee and the partnership (as constituted after the distribution).

(c) Unrealized receivables. — For purposes of this subchapter the term "unrealized receivables" includes, to the extent not previously includible in income under the method of accounting used by the partnership any rights (contractual or otherwise) to payment for —

(1) goods delivered, or to be delivered, to the extent the proceeds therefrom would be treated as amounts

received from the sale or exchange of property other than a capital asset, or

(2) services rendered, or to be rendered.

d) Inventory items which have appreciated substantially in value. —

(1) Substantial appreciation. — Inventory items of the partnership shall be considered to have appreciated substantially in value if their fair market value exceeds —

(A) 120 percent of the adjusted basis to the partnership of such property, and

(B) 10 percent of the fair market value of all partnership property, other than money.

(2) Inventory items. — For purposes of this subchapter the term "inventory items" means —

(A) property of the partnership of the kind described in section 1221(1).

(B) any other property of the partnership which, on sale or exchange by the partnership, would be considered property other than a capital asset and other than property described in section 1231, and

(C) any other property held by the partnership which, if held by the selling or distribute partner, would be considered property of the type described in subparagraph (A) or (B). Aug. 16, 1954, 9:45 a.m., E.D.T. c. 736, 68A Stat. 250.